

**Budget Hearing for the Independent Fiscal Office**  
**House Appropriations Committee**  
**February 11, 2019**

Good morning Chairmen and members of the committee. I appreciate the opportunity to testify before you today. To provide some context for the packet that has been submitted for this budget hearing, I would like to discuss recent economic and revenue trends. I would also like to make some brief comments regarding the IFO's recently published performance-based budget (PBB) plans and tax credit reviews.

**Revenue Update for FY 2018-19**

Through January, actual revenues exceed the IFO official revenue estimate by \$321 million (and the Administration's estimate by \$290 million). However, for January, revenues were roughly \$100 million below estimate due to a shortfall in the fourth estimated payment for personal income tax. The year-to-date net overage is attributable to three sources: sales and use tax (\$205 million over estimate), corporate net income (\$191 million) and gaming expansion (\$64 million). Those amounts were partially offset by a shortfall in personal income tax (-\$197 million). Details regarding the gains and losses are as follows:

- The extra sales tax monies are largely due to the underestimate of the impact from Act 43 of 2017, which required all internet sellers with annual sales above \$10,000 in the state to collect tax or comply with reporting requirements. The revised estimate of this provision increases revenues by roughly \$200 million. This is a permanent gain.
- The IFO believes the corporate net income tax gains are due to (1) more profit shifting than originally estimated (due to federal tax law changes), (2) higher pre-tax profits than assumed and (3) an unexpected pull-forward of settlement payments for old tax years to benefit from the higher federal deduction of state taxes at the 35% rate (tax year 2017) versus the lower 21% rate (tax year 2018). If correct, much of these gains are temporary.
- More licenses issued for both sports wagering and iGaming. These gains are temporary.
- A significant decline in the stock market for 2018 Q4 reduced personal income tax estimated payments. The IFO also speculates that taxpayers likely had a large stock of overpayment credits from the prior tax year that they opted to apply to the fourth estimated payment. This shortfall is temporary.

**Pennsylvania Economy**

The state economy appears to be operating at full capacity, with the unemployment rate at 4.2% (December 2018), strong net jobs growth (roughly 73,000 net new payroll jobs in 2018) and wages increasing at a solid pace (4.3% for 2018 Q4). Moreover, median existing home values increased by 4.3% in the latest quarter (2018 Q3) while per capita consumer debt increased modestly (1.8%) for the entire year. Overall, these data suggest sound economic fundamentals and potential for further expansion into next fiscal year.

However, there are some headwinds for this year and next that suggest policymakers should expect slower economic growth. They are as follows:

- There has been significant volatility in the stock market. Consumers are more reluctant to spend under such conditions. The latest readings of the consumer confidence index reveal that confidence has dropped for the latest two months.
- International economic growth appears to be decelerating across all major U.S. trading partners: the European Union, Canada, Mexico, China and Japan.
- The recent federal tax cut will begin to shrink in size as some provisions are phased out or begin to reverse themselves (e.g., bonus depreciation). Although a substantial tax cut remains, the reduction in absolute size will have negative implications for growth.

The main point of strength for the state economy is the robust labor market. For 2018, preliminary data suggest that the state economy produced more net payroll jobs than any year since 2000. The data also show that average wages grew by 3.0% compared to consumer inflation of 1.5%. The only downside to the state labor market is that nearly one-third of the net new jobs created occurred in three low-wage sectors: food service, social assistance and home healthcare. Due to flat demographic growth, the IFO expects that the state unemployment rate will remain low and service industry jobs will comprise the majority of net new jobs created.

### **Performance Based-Budgeting (PBB) and Tax Credit Reviews**

In January 2019, the IFO submitted five PBB plans and three tax credit reviews to the PBB Board for their review. These reports represent the first year of a five-year cycle where all agencies under the governor's jurisdiction and all tax credits will come under review. The PBB plans for the first year will be used as a foundation to build more comprehensive reports in future years. For these first year reports, the IFO sought to accomplish the following goals:

- Research models used in other states that currently employ PBB systems such as Washington, New Mexico, Nevada and Kansas.
- Establish the data template that will be used across all agencies to compile relevant data.
- Establish the format to be used across all agencies to allow maximum flexibility and information content.

These goals were attained for the first year reports. For future years, this same foundation will be used, but the reports will include more outcome-based metrics and benchmark comparisons. The construction and vetting of those types of measures require significant lead time and numerous interactions with agency staff in Pennsylvania and other states as well. It should be noted that a full PBB system must also include other data and content to support and provide context for performance measures. For example, a comprehensive PBB approach should itemize the agency activities (i.e., services provided) for each measure, and delineate their goals and desired outcomes. Actual expenditures and full-time equivalent staff must also be computed so that the inputs to those activities are accurately measured.

The three tax credit reviews included the New Jobs, Historic Preservation and Film Production Tax Credits. The reviews included interstate comparisons and the computation of relevant economic metrics, such as net jobs created and return on investment. When possible, the IFO intends to compute similar performance metrics for all tax credits so that policymakers can compare outcomes across the various economic incentive programs. A comparison of the programs may facilitate an overall strategy that could be used to target limited incentive funds to their best use.